

Tax Facts

A knowledge-based series by the
Tax and Transfer Policy Institute

What Is Bracket Creep?

Bracket creep occurs when individuals pay higher tax rates on their income because of inflation. This is the result of a combination of a progressive tax system, tax thresholds that do not automatically change with inflation, and changes to price levels in the economy. The term 'bracket creep' is derived from two terms: tax rates in Australia are based on income ranges, or tax brackets, and as time goes by individuals move, or 'creep', into higher tax brackets gradually, sometimes unknowingly.

Three components of bracket creep

1. Progressivity of the personal income tax

The Australian income tax has been designed as a progressive tax. This means that the higher an individual's income (from wages, salary, investment returns, interest on bank deposits, et cetera), the greater the percentage of tax they must pay on this income. The marginal income tax rates are presented in Figure 1. For example, in the 2018-19 financial year, the first \$18,200 of an individual's income was tax free, while every dollar earned between \$18,201 and \$37,000 was taxed at 19c, and so on.

Figure 1. Australia's tax brackets 2018-19
(for residents, excludes Medicare levy)

Taxable income	Tax on this income
0 – \$18,200	Nil
\$18,201 – \$37,000	19c for each \$1 over \$18,200
\$37,001 – \$90,000	\$3,572 plus 32.5c for each \$1 over \$37,000
\$90,001 – \$180,000	\$20,797 plus 37c for each \$1 over \$90,000
\$180,001 and over	\$54,097 plus 45c for each \$1 over \$180,000

2. Unindexed tax thresholds

The tax brackets presented in Figure 1 do not automatically change when inflation occurs; they need to be legislated. For instance, the government legislated an increase in the 37c tax bracket from \$87,000 to \$90,000 for the 2018-19 financial year.

3. Changes to price levels in the economy

The price of a good or service in the economy is not constant. On average, the prices of most goods and services in Australia have slowly risen over time. This might seem like a problem if a person's income remains the same, since an individual's money would buy fewer goods or services over time. However, incomes also rise, so an individual is usually still able to buy as many goods and services as before. As a result, while someone's income may have increased from \$50,000 to \$60,000 over five years, their standard of living may have stayed the same or even improved. When prices rise over time it is referred to as inflation. For example, if a good cost \$1.00 one year, and \$1.10 the next, the inflation rate for that year would be 10 per cent. Australia's Reserve Bank, which prints and looks after Australia's currency, aims to keep the annual inflation rate in Australia between 2-3 per cent. In Australia over the past twenty years, wages have increased at a faster pace than inflation.

There are two types of increases in income: nominal and real. Increases in the face value of income, like the price of a good in the supermarket or on one's paycheck, are referred to as *nominal* increases. By contrast, *real* increases in income increase the amount of goods and services that an individual can purchase. Real increases in income exceed inflation. For instance, if someone's nominal income increased by 10 per cent and the rate of inflation was also 10 per cent, their real income would remain the same. By contrast, if someone's nominal income increased by 12 per cent and the rate of inflation was 10 per cent, their real income would have increased by 2 per cent.

So, why is bracket creep a problem?

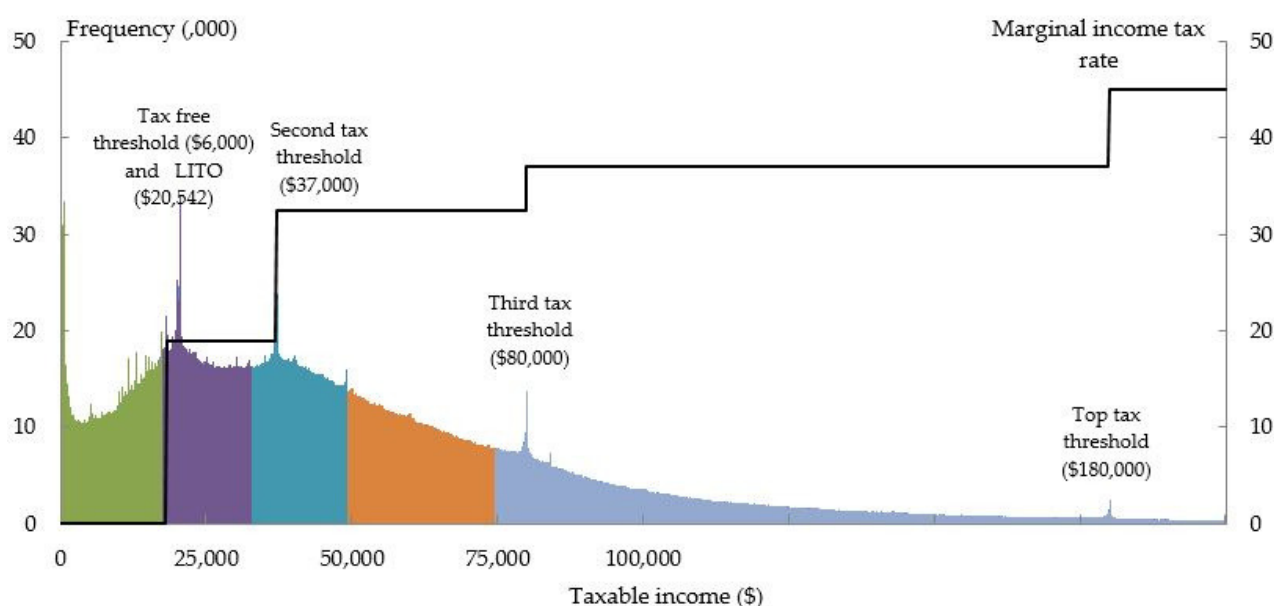
While some level of inflation is not a big problem, it does present implications for Australia's tax system. Bracket creep occurs when tax brackets remain the same and people's nominal incomes rise due to inflation. As a result, over time, more and more people are pushed into higher tax brackets, without experiencing a corresponding increase in their purchasing power.

Bracket creep can also impact workers by influencing their incentive to work. Bracket creep implies that every additional dollar that a worker earns may be taxed at a higher rate, potentially discouraging them from additional hours of work, or from working at all. This could result in undesirable outcomes, like reduced workforce participation.

The effects of bracket creep are presented in Figures 2 and 3. Figure 2 shows the distribution of individuals, by taxable income, for the 2012-13 financial year. Figure 3 shows individuals' taxable income in 2015-16. Since marginal income tax rates did not change between 2012 and 2016, a greater share of individuals pay a higher tax rate on part of their income.

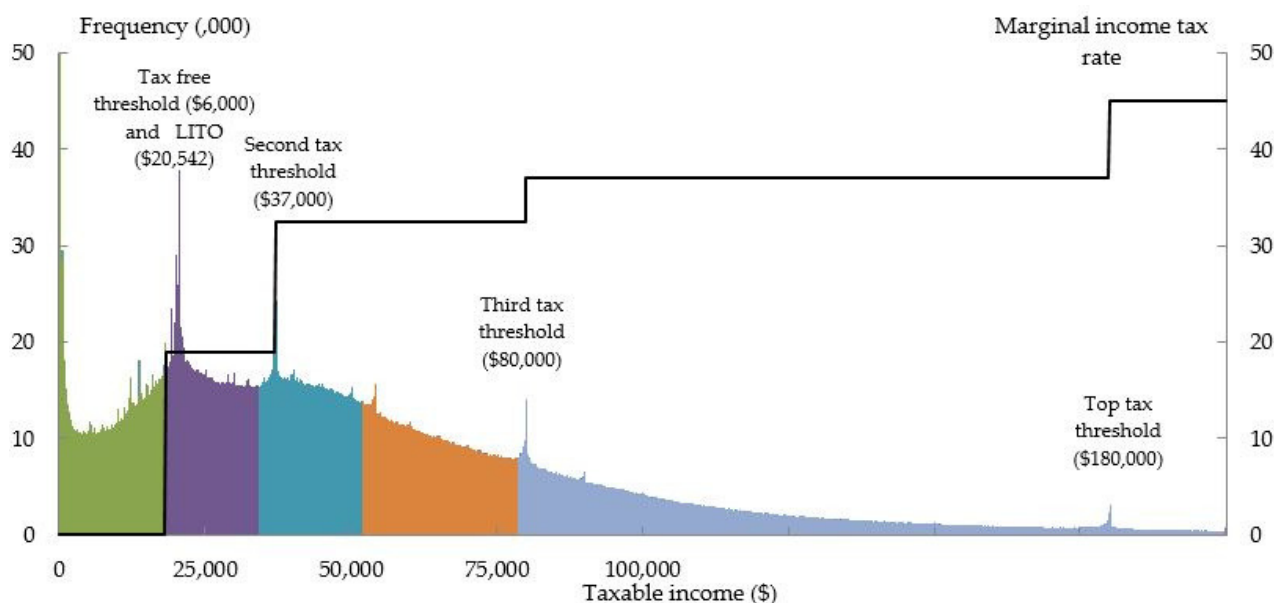
This is illustrated by Figure 3, which shows how a portion of each of the quintiles (colours) shifts to the right into a higher marginal income tax bracket. This is particularly visible from the third quintile (teal), where about 25% of the quintile was subject to the 19c marginal income tax rate in 2012-13, but nearly all of the quintile is subject to the higher, 37c marginal income tax rate in 2015-16. Similarly, in 2012-13, three marginal income tax rates (32.5c, 37c, and 45c) applied to the richest quintile of taxpayers. However, by 2015-16, only two tax rates (37c and 45c) applied to nearly all of the richest taxpayers in the top quintile.

Figure 2. The distribution of taxpayers by taxable income, 2012-13



Source: TPI calculations.

Figure 3. The distribution of taxpayers by taxable income, 2015-16



Source: TTPI calculations.

How can bracket creep be fixed?

One way in which the negative effects of bracket creep can be mitigated is by increasing the tax brackets in line with the general rate of inflation in the economy. This would ensure that only real increases in income push individuals into higher tax brackets.

So why are tax brackets not indexed to inflation?

Governments are reluctant to index tax brackets to inflation because bracket creep allows them to automatically increase tax revenue every year, without having to engage in rancorous debate about increasing taxes. As individuals are pushed into higher tax brackets by inflation, the total amount of income tax revenue collected by the government increases. If government expenditure increases over time, bracket creep often provides an easier way (politically) to secure funding, compared with an explicit increase in taxes.

Eliminating bracket creep would also reduce the government's flexibility to offer tax cuts in times of budget surplus and to save the proceeds from bracket creep in times of budget deficit.

Are there any benefits from bracket creep?

Personal income taxes are a major source of revenue for governments, which allow them to plan for and deliver public goods and services. As a result, while individuals, on average, may feel they are worse off directly due to bracket creep, they may still benefit from the government spending it facilitates.

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